

Assessing China's Bitcoin 'Mining Ban'

Jan. 8.18 | About: Winklevoss Bitcoin (COIN)

Summary

- Although rumors about China's intention to ban bitcoin mining were subsequently invalidated, market players continued to believe such a move would be highly positive for bitcoin prices.
- I sought to explain in this article the significance of such a ban if it is actually implemented.
- My belief is that miners have ample time to react and thus there should be limited, if any, impact on the price of bitcoins.
- Readers are encouraged to participate in the poll and share your thoughts in the comments section.

Exuberance And Irrational Market Behavior In The Cryptocurrency Field

Bitcoin (COIN), its related investment trust (OTCQX:GBTC), and other cryptocurrencies have hogged global financial headlines in the past year. Attention on the price developments of the cryptocurrencies, discussions on whether it is a Ponzi scheme, the debate on whether it is in a bubble, etc., reached a fever pitch in the last quarter of 2017. As a financial writer and an avid reader of investment news, it has been intriguing to read about the strong arguments from both sides of the camp.

Amazement turned to disbelief when the stock prices of a handful of old-fashioned companies skyrocketed almost overnight the moment the management went public on their plans to involve themselves in the blockchain technology. A recent example is Long Island Iced Tea Corp., which upon declaring its aspiration to acquire businesses dealing with cryptocurrencies and changing its name to Long Blockchain Corp. (LBCC), its share price nearly quintupled on the news. This was despite it having terrible Altman Z-Score which is not only negative but the worst of the lot compared to several of its peers (see the table below). While the model is not a perfect one, the Altman Z-Score is nonetheless a decent gauge of the probability of a company going bankrupt. According to Ycharts, the companies with a Z-Score of less than 1.81 have a relatively high probability of bankruptcy.

Ticker	Name	Altman Z-Score
LTEA	Long Island Iced Tea Corp.	(6.0)
REED	Reeds, Inc.	(1.5)
COT	Cott Corporation	1.4
TAP	Molson Coors Brewing Company	1.7
DPS	Dr Pepper Snapple Group, Inc	2.7
SECTOR:STPL	Consumer Staples	3.4
KO	Coca-Cola Company (The)	3.4
PEP	Pepsico, Inc.	3.8
CCU	Compania Cervecerias Unidas, S.A.	4.6
ABEV	Ambev S.A.	8.5
MNST	Monster Beverage Corporation	25.2

(Source: *finbox.io*)

It is such irrational market behavior and exuberance in the blockchain sphere and specifically the cryptocurrency space that I felt obliged to research on one rumor being touted fervently as the next major development for bitcoin and the other cryptocurrencies among my investor-friends. That rumor was the supposed "mining ban" by the Chinese government. The issue has global implications as Chinese bitcoin traders continue to exert significant influence in the market.

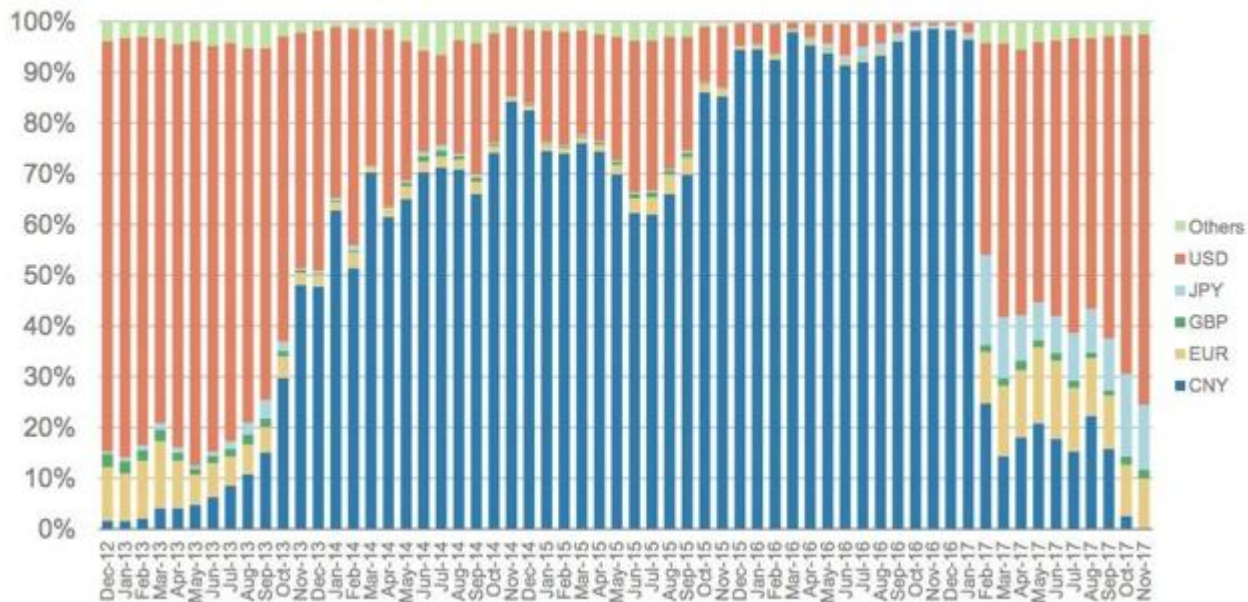
China Remains A Dominant Player In The Bitcoin Market Despite Crackdowns

China dominated the bitcoin market for a good three years from 2014 to 2016 (see the chart below) based on the trading by the local currency - Yuan. That all changed in December 2016 when the People's Bank of China, the Chinese central bank, issued a notice forbidding financial institutions on the mainland to transact in bitcoins. Through 2017, the Chinese government further clamped down on bitcoins, banning cryptocurrency exchanges altogether in September.

Bitcoin Transaction By Currency Of Trade (Historical)

Where are trades happening? A list of currencies:

Bitcoin/fiat trade composition, by currency

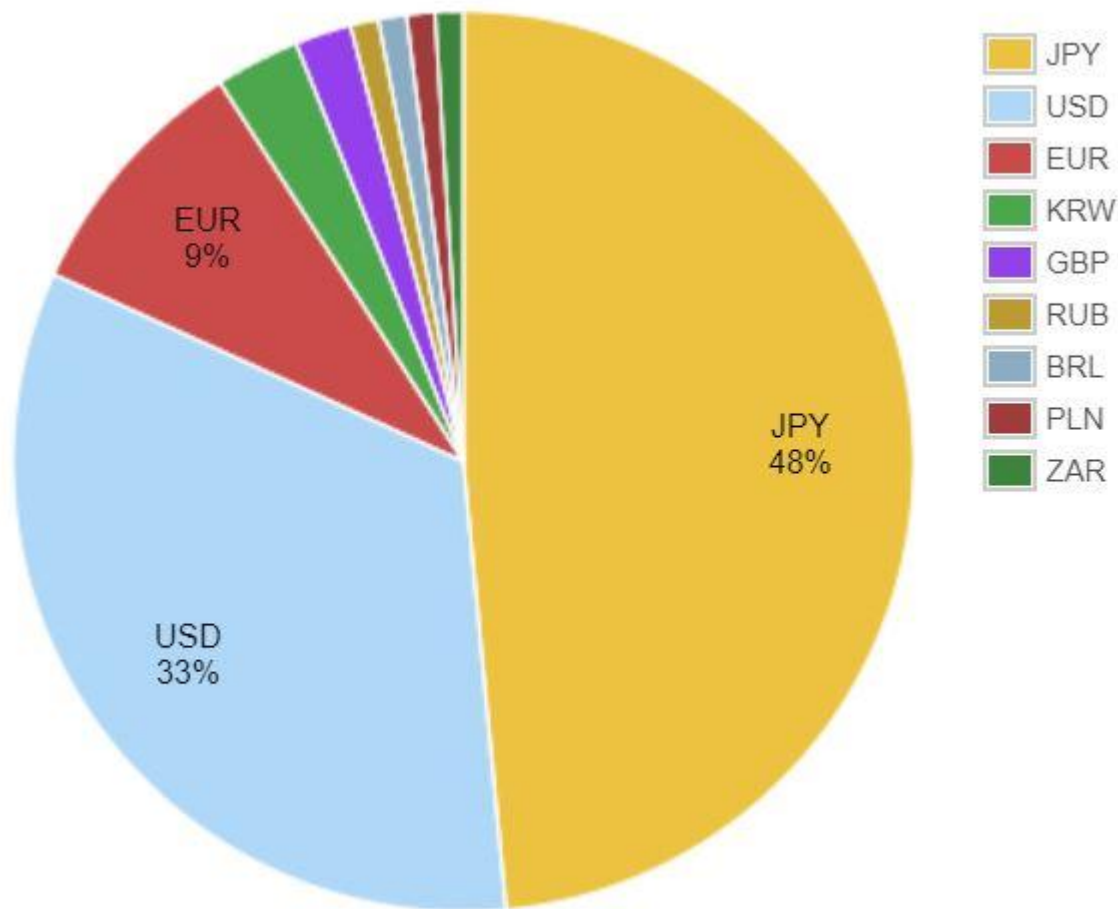


Source: blockchain.info, Morgan Stanley Research

(Source: *blockchain.info*, *Morgan Stanley Research*)

As a result, yuan-to-bitcoin volume was obliterated by November last year. Japanese Yen became the dominant trading currency (see the chart below). However, the influence of the Chinese is expected to remain significant as they have alternative ways to perform their bitcoin trading. The ability of the Chinese to circumvent government restrictions has been demonstrated in the other areas like the use of VPNs to overcome the Great Firewall of China. Casinos worldwide have also been used to launder money by the Chinese. Despite tighter controls on money outflow, companies and individuals still managed to sneak money out of the country. Hence, bitcoin players should not belittle the impact of developments in the country purely based on the zero volume of yuan-to-bitcoin trading.

Bitcoin Transaction By Currency Of Trade (Last 30 Days)



(Source: Bitcoincharts.com - as of 6 January 2018)

Government Seizure Of Bitcoin Mines in China?

Rumors of Guo Hongcai, a popular bitcoin advocate and industry investor, purportedly claiming that he had received information on the seizure of all bitcoin mines after the 5th (of January) was furiously disseminated via social media. This was said to be based (content in Chinese) on a screenshot of WeChat, the ubiquitous messaging app used in China. The topic gained credence after the circulation of another message from some media outlets that the central bank had held a closed-door meeting on January 3rd to determine a deadline for terminating bitcoin mining.

Such a development is deemed unsurprising for the public given the apparent omnipresence of the local authorities. Readers in my article regarding a Chinese Tesla-wannabe pointed out the heavy-handed manner of the government. Similar discussions surfaced in the article on Alibaba's potential. Thus, given the backdrop, it is not difficult to understand why the rumors were not easily dismissed. Furthermore, it is not the first time that a "ban" has caused an alarm among the miners. In November, a state-owned local electric utility company issued a letter to power stations under its charge that the provision of power to bitcoin miners meant that they were complicit in the illegal act of bitcoin

mining. Observers commented that such action was tantamount to an official ban on bitcoin mining. However, the state-owned utility subsequently clarified (paywall) that there were some errors in the phrasing and that there was, in fact, no ban.

A ban on bitcoin mining in China will certainly have a big impact on the supply of the coins. China accounts for around 70 percent of the mining capacity. A sudden plunge in the output of bitcoins with the frenzy to own them still remaining high would result in a shortage and consequently a surge in the price of bitcoins. This is simple logic and basic supply and demand economics. To understand how production curtailment can impact prices, look to the crude oil market. I believe most readers are aware that the crude oil prices have been kept firm thanks to the agreement among key oil producing countries (OPEC and Russia) to limit their outputs. A similar outcome would happen for bitcoins.

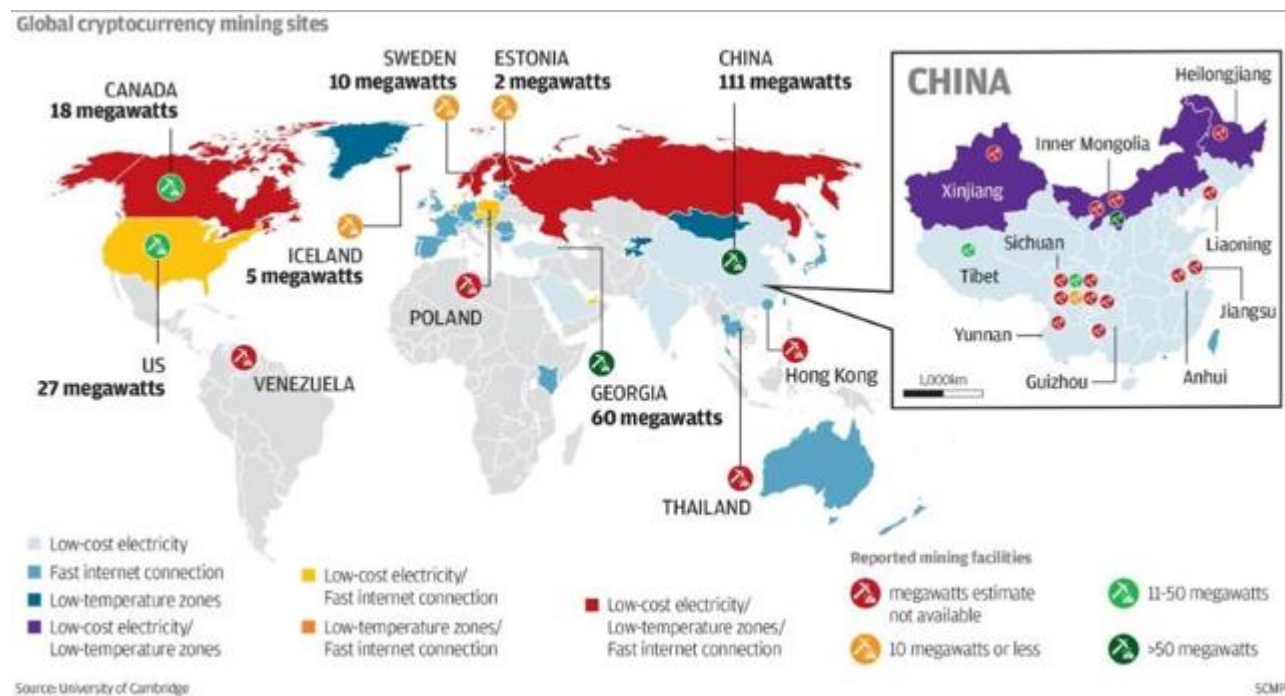
Bitcoin miners in other countries could (and would, with the increase in prices) step up to fill in the gap. However, that would take time due to the setup required. Mining operations in China could also shift their equipment overseas, though that would not be easy and quick either, given the different jurisdictions involved. The miners would need time to evaluate the host country, seek the space required, and work out the logistical challenges.

Alas, the bitcoin hopefuls were disappointed as the rumors were later invalidated. The protagonist in the story, Guo Hongcai, rubbished the WeChat message, refuting he said anything regarding the matter. He also indicated that the screenshot was photoshopped. The finance publication, Caixin, subsequently cited "authoritative figures" that the so-called internal meetings did not happen and no deadline was set for shutting down bitcoin mining operations.

Limited Impact On Prices In The Event Of A Repeat

While the "mining ban" turned out to be false, any bitcoin miner worth its salt should have taken this episode as an early warning that the ban could indeed happen in the future. The miner should, therefore, seek out suitable sites in other countries to shift its operations in advance of a potential ban in China. It is not an easy decision to make as the very reason miners have sprung up in large numbers in China is the cheap electricity. In Ordos, the provincial city of Inner Mongolia where coal-fired power dominates, Bitmain, a key miner, was said to be enjoying a subsidized electricity rate of just 4 US cents per kilowatt-hour. That is much cheaper than in the US and most European Union countries. Those that could negotiate directly with hydropower stations present in the mountainous Yunnan and Sichuan provinces paid even lower rates - less than 2 US cents per kWh.

Without any ban, cryptocurrency miners would still eventually have to face higher electricity costs. The miners enjoyed cheap electricity as the transmission network to transfer power from the oversupplied north and west to the east has yet to complete. When the power system is fully functional, the utility would no longer need to offer subsidies to the mining operations. The miners know this and so they have ample time to plan ahead. An ideal alternative location would have both low-cost electricity and fast internet connection. A site with a low-temperature climate would also help in the cooling of the processors and reduce the need for electrified coolers. There are quite a number of options as illustrated by the University of Cambridge (see the map below).



(Source: University of Cambridge, SCMP)

Conclusion

I set off to research and write this article due to the perception that investors appeared to deem the rumored mining ban as highly bullish to the price of bitcoins (and other cryptocurrencies). It is basic supply and demand economics, of course. A mining ban would lead to production curtailment and a shortage, which in turn drive up prices. However, it seems that the Chinese government has no intention to prohibit the mining of bitcoins. Why should they, since the mining activities contribute positively to the economy. The heavy electricity consumption also helped to soak up the capacity in the northern provinces which would otherwise be underutilized.

Hence, if investors are touting a potential ban as a bullish factor for bitcoin prices, they are looking the wrong way. Even if such a ban is imposed in the future, the impact would be limited as miners have ample warnings.

Do you agree? Please vote in the poll below and **voice out your choice** in the comments section so that Seeking Alpha readers and I can understand what you have in mind!

Will China ban bitcoin mining?

Will China ban bitcoin mining?

- ☐ Yes, and it will be bullish for the price of bitcoins.
- ☐ Yes, but there will be limited impact on the price of bitcoins, if any.
- ☐ No, why should they?

SUBMIT

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